

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 04-0016
GROSS RETAIL TAX
For 2002 and 2003**

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ISSUE

I. Aircraft Purchase – Gross Retail Tax.

Authority: IC 6-2.5-4-10(a); IC 6-2.5-4-10(b); IC 6-2.5-2-1; IC 6-2.5-5-1 to 70; IC 6-2.5-5-8; Gregory v. Helvering, 293 U.S. 465 (1935); Horn v. Commissioner of Internal Revenue, 968 F.2d 1229 (D.C. Cir. 1992); Commissioner v. Transp. Trading and Terminal Corp., 176 F.2d 570 (2nd Cir. 1949); 45 IAC 2.2-4-27(a); 45 IAC 2.2-4-27(d); 45 IAC 2.2-4-27(d)(1); 45 IAC 2.2-5-15(b)(1), (c)(2); Blacks Law Dictionary (7th ed. 1999).

Taxpayer argues that it was not required to pay gross retail (sales) tax when it purchased an airplane because the airplane was purchased in order to lease it to others during the regular course of taxpayer's business.

STATEMENT OF FACTS

Pilot/lessee formed and invested money in an S-Corporation (taxpayer). Taxpayer bought an airplane in August of 2002. The airplane cost \$275,000.

In August of 2002, pilot/lessee and taxpayer entered into an "Aircraft Hourly Rental Agreement." Pilot/lessee agreed to pay a "base rent" of \$2,000 as a "Deposit on the First Year's Rent." In addition, the pilot/lessee agreed to pay a regular hourly rate for the use of the aircraft. Under the terms of the agreement, the "[t]otal hourly rent shall be the sum of the hourly rent amount of \$380 per hour, multiplied by flight time . . . reduced by offset expense payments" Those "expense payments" were defined elsewhere in the agreement to include "scheduled and non-scheduled maintenance . . . hangar and storage charges while at home base, insurance premiums for insurance coverage . . . and property and ad valorem taxes."

In October 2002, taxpayer submitted to the Department an "Application for Aircraft Registration or Exemption." On that form, taxpayer indicated that the aircraft was purchased "for the following exempt use." Taxpayer specified that the aircraft was purchased for "Rental or Lease to Others per IC 1971-6-2.5-5-8."

In November 2002, taxpayer was issued by the Department a “Registered Retail Merchant Certificate.” The certificate directed taxpayer to report its estimated sales – lease income – on a monthly basis and that the “first remittance [was] due on or before 09/30/2002.”

The Department sent taxpayer a letter dated December 2002 in which it stated that – based upon the information taxpayer supplied to the Department – the aircraft was not being used for the purpose of rental to others. Therefore, the Department denied taxpayer the sought-after exemption directing that taxpayer pay the approximately \$15,000 in sales tax based upon the original purchase price of the airplane. In January of that same year, taxpayer’s representative protested the denial.

The Department sent taxpayer a letter dated June 2003 in which it noted that taxpayer had failed to file monthly sales tax returns for December of 2002 through April of 2003. In addition, the Department pointed out that taxpayer had filed “zero” returns for September, October, and November of 2002. In sum, taxpayer failed to file sales tax returns or filed “zero” returns for eight months. The Department requested clarification from taxpayer or indicated that “the claim for sales/use tax exemption on the purchase of the subject aircraft will be denied”

Taxpayer’s representative responded in July indicating that the \$2,000 base rent amount – specified in the parties lease agreement – which had been due November 2002 was not paid until July 2003 and that this “payment and all future rental payments will be reported and paid timely.”

The Department responded later that same month questioning the basis for the numerous “zero” returns. The Department pointed out that the parties’ agreement specified that the pilot/lessee would pay \$380 for each hour the plane was used; therefore, taxpayer was to pay sales tax on a monthly basis even if the taxpayer and the pilot/lessee chose to reconcile the amount due on a yearly basis.

In August of 2003, taxpayer’s representative responded indicating that taxpayer “is a cash basis taxpayer that rents the aircraft on an annual basis.” The representative pointed out that taxpayer had paid sales tax on the \$2,000 “base lease” but that no other lease amounts had been invoiced and that “there are no rental invoices to provide to you.”

The Department sent a letter dated September 2002 stating that taxpayer “has not provided any evidence of rental or lease transaction between [taxpayer] and the [pilot/lessee] including the billing and collection of the initial payment.” The Department concluded that the “exemption from sales tax due on the purchase of the aircraft has been denied and a proposed assessment of sales tax due has been issued.” True to its word, the Department issued notices of “Proposed Assessment” for the amount of the sales tax that would have been otherwise due on the initial purchase price of the airplane if taxpayer had not claimed that the airplane was being bought for an exempt purpose.

Additional correspondence between taxpayer and the Department followed. Taxpayer protested the assessment of additional sales tax, an administrative hearing was conducted during which

taxpayer was given the opportunity to explain the basis for its protest, and this Letter of Findings results.

DISCUSSION

I. Aircraft Purchase – Gross Retail Tax.

Taxpayer argues that the Department erred in rejecting its assertion that the aircraft was purchased for an exempt purpose.

Indiana imposes a gross retail (sales) tax on retail transactions in Indiana. IC 6-2.5-2-1. The legislature has provided a number of exemptions to the imposition of that tax. *See* IC 6-2.5-5-1 to 70. One of those exemptions is provided at IC 6-2.5-5-8 which states that, “Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of his business without changing the form of the property.”

Therefore, if taxpayer bought the airplane for the purpose of leasing it to others, taxpayer was not required to pay sales tax on the purchase price because taxpayer bought the plane for “an exempt purpose.”

However, once a person – such as taxpayer – gets into the business of leasing personal property, that person is required to collect sales tax on the lease payments. IC 6-2.5-4-10(a) states that, “A person, other than a public utility, is a retail merchant making a retail transaction when he rent or leases tangible personal property to another person.”

The Department’s regulation defines what it is that a person in the leasing business should be collecting sales tax on. 45 IAC 2.2-4-27(a) states that, “In general, the gross receipts from renting or leasing tangible personal property are taxable. This regulation [] only exempts from tax those transactions which would have been exempt in an equivalent sales transaction.”

The regulation further defines “gross receipts” obtained from leasing tangible personal property. “The rental or leasing of tangible personal property, by whatever means effected and irrespective of any terms employed by the parties to such transaction is taxable.” 45 IAC 2.2-4-27(d).

For the benefit of those lessors who feel that the above language is in anyway ambiguous, the regulation further states that, “The amount of actual receipts means the gross receipts from the leasing of tangible personal property without any deduction whatever for expenses of costs incidental to the conduct of the business. The gross receipts include any consideration received from the exercise of an option contained in the rental [or] lease agreement” 45 IAC 2.2-4-27(d)(1).

Taxpayer has a lease agreement with pilot/lessee. The agreement provides that the pilot/lessee will pay \$380 for each hour that the pilot/lessee uses the aircraft. Therefore, if pilot/lessee uses the aircraft for 10 hours, the pilot/lessee owes taxpayer \$3,800. However, the parties’ agreement also provides that if taxpayer incurs expenses associated with the aircraft, the total amount due

from the pilot/lessee will be reduced by the amount of those expenses. For example, if taxpayer incurs \$3,000 in related expenses during the lease period cited in the example above, pilot/lessee will owe \$800. If – by sheer happenstance – taxpayer incurs \$3,800 in expenses during this same period, pilot/lessee will owe \$0.

It may be reasonably assumed that taxpayer will incur substantial expenses in maintaining, hangaring, and insuring this aircraft; thus, it may also be assumed the pilot/lessee's lease payments will be reduced by a corresponding amount.

The specific agreement provision – reflecting an unparalleled spirit of generosity on the part of taxpayer – offsetting lease payment by the amount of aircraft expenses, is in derogation of 45 IAC 2.2-4-27(d)(1). That regulation requires a lessor to collect sales tax on gross receipts “without any deduction whatever for expenses or costs incidental to the conduct of the [lessor's] business.” *Id.* Taxpayer may not side-step this requirement by means of the parties' artfully drafted agreement. In plain words, the regulation provides that “The rental or leasing of tangible personal property, *by whatever means effected and irrespective of the terms employed by the parties to describe such transaction*, is taxable.” 45 IAC 2.2-4-27(d) (*Emphasis added*). However, whether taxpayer should have been collecting sales tax on the basis of the \$380 per-hour charge or on the basis of a \$0 per-hour charge is finally irrelevant. Similarly, whether taxpayer should have been collecting and paying sales tax on a monthly or yearly basis is also irrelevant because – as a matter of fact, law, and simple common sense – there is no lessee/lessor relationship here.

A lease is defined as “[a] contract by which the rightful possessor of personal property conveys the right to use that property in exchange for consideration.” Blacks Law Dictionary 898 (7th ed. 1999). The parties' agreement reflected the fact that pilot/lessee never expected to pay consideration sufficient to justify recognizing the agreement as a lease. Instead, the “Aircraft Hourly Rental Agreement” falls squarely within the definition of a “sham transaction.” The “sham transaction” doctrine is long established both in state and federal tax jurisprudence dating back to Gregory v. Helvering, 293 U.S. 465 (1935). In that case, the Court held that in order to qualify for a favorable tax treatment, a corporate reorganization must be motivated by the furtherance of a legitimate corporate business purpose. *Id.* at 469. A corporate business activity undertaken merely for the purpose of avoiding taxes was without substance and “[t]o hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.” *Id.* at 470. The courts have subsequently held that “in construing words of a tax statute which describe [any] commercial transactions [the court is] to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation.” Commissioner v. Transp. Trading and Terminal Corp., 176 F.2d 570, 572 (2nd Cir. 1949), *cert denied*, 338 U.S. 955 (1950). “[t]ransactions that are invalidated by the [sham transaction] doctrine are those motivated by nothing other than the taxpayer's desire to secure the attached tax benefit” but are devoid of any economic substance. Horn v. Commissioner of Internal Revenue, 968 F.2d 1229, 1236-37 (D.C. Cir. 1992).

The Department was correct in determining that taxpayer owed sales tax on the initial purchase price of the aircraft because taxpayer was never engaged in leasing the aircraft in the ordinary

course of its business. *See* IC 6-2.5-4-10(b); 45 IAC 2.2-5-15(b)(1), (c)(2). The “Aircraft Hourly Rental Agreement” was not an agreement to rent or lease an airplane but was a fanciful document drafted “for no other motive but to escape taxation.” Transp. Trading and Terminal Corp., 176 F.2d 570, 572. The parties’ lease agreement has no economic substance or rationale and, for purposes of determining sales tax liability, should be entirely ignored.

FINDING

Taxpayer’s protest is respectfully denied.

DK/JM/MR – 042503